

Testimony of
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Of the Committee on Government Reform
Hearing on the SEC's Implementation of the Sarbanes-Oxley Act
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Addressing the Unintended Burdens of the Sarbanes-Oxley Act

Madame Chairman, Ranking Member Lynch and members of the Subcommittee, thank you for the opportunity to testify today. I am Alex Pollock, a Resident Fellow of the American Enterprise Institute, and these are my personal views on the need for action to address the unintended, but very real, excessive burdens and bureaucracy created by the implementation of the Sarbanes-Oxley Act of 2002.

Implementation Bureaucracy

This hearing is important and timely. With more than three years of national experience with Sarbanes-Oxley implementation to consider, Congress can now easily see that its good intentions have resulted in notable adverse consequences. I am sure you have heard a lot about this from the businesses in your own districts.

Let us start with the most obvious unintended results. Sarbanes-Oxley implementation activities, particularly the Section 404 certifications which have become notorious, have created a tremendously expensive amount of paperwork and bureaucracy. The explicit costs alone are extremely high and disproportionately high for smaller companies. The implicit costs of employee and management time and effort are high. In addition, there

are the opportunity costs of diversion of management focus from playing offense to playing defense.

The total costs far outweigh the benefits which are likely to arise from them, especially for smaller companies.

This is especially true because the testimony of history is quite clear on the reliable regularity with which frauds and scandals accompany investment booms and bubbles. In my opinion, the detailed rules, bureaucratic overhead, and mechanical requirements which characterize Sarbanes-Oxley implementation will not prevent fraud and scandal during the next boom when it comes.

In a typical view of its Sarbanes-Oxley experience, frankly expressed, one smaller company's letter to the SEC describes the following: "concentration on minutia...redundant and inefficient...adversarial relationship with audit firm...form over function...unrealistic requirements on small and developing companies." It further points out that the cost of all this, which far exceeded the estimates, is of course money taken away from its shareholders.

A letter from the British Confederation of Industry correctly observes that "Dealing with risks on the basis of a remote likelihood," which is the Sarbanes-Oxley implementation approach, "not only imposes huge costs but also makes this a nitpicking process."

An American trade association letter describes, "An atmosphere of near paranoia...the public accounting firms have increased their aversion to risk to an extreme degree."

On the disproportionate negative impact on smaller companies, the SEC's Advisory Committee on Smaller Public Companies has recently concluded: "The result is a cost/benefit equation that, many believe, diminishes shareholder value, makes smaller public companies less attractive as investment opportunities and impedes their ability to compete.... We believe Section 404 represents a clear problem for smaller public companies and their investors, one for which relief is urgently needed."

Another commentator, Eliot Spitzer, has described Sarbanes-Oxley implementation as an "unbelievable burden on small companies."

Congress clearly did not intend all this. The SEC did not intend it either, nor did it know what the effects of its regulation would be. This is apparent from the initial SEC estimate of a cost of \$91,000 per company on average, an estimate which appears to be low by a factor of 50 or so. Either the SEC staff had very little understanding of what their regulation actually required, or interpretation of the regulation morphed in ways never imagined. Indeed, the SEC and the PCAOB subsequently criticized the accounting firms quite sharply for what Sarbanes-Oxley implementation has become.

In short, no one intended the outcome we've got. I believe it's time to fix it.

Effects on Accounting Firms

The flip side of the enormous expense and distraction for companies is that for the large public accounting firms, Sarbanes-Oxley implementation has been a revenue and profit bonanza. One journalist called it the greatest wealth transfer of modern times, from shareholders of companies to partners of accounting firms.

This is especially ironic since Congress was quite clear that this was not its intent. The Senate Committee Report on Section 404 was specific: “The Committee does not intend that the auditor’s evaluation be the subject of a separate engagement or the basis for increased charges or fees”! (emphasis added) . Nevertheless, virtually every audit committee in the country has helplessly watched its audit fees escalate dramatically, unable to exercise any judgment about whether the expensive routines make sense for their shareholders.

A second irony is that the implementation of an act dedicated to controlling conflicts of interest has created an obvious conflict of interest for the accounting firms themselves. The more massive the Sarbanes-Oxley routines, the more memos, procedures and risk control descriptions which are generated, the more often they are reviewed and revised, the more meetings, the more interviews of managers, the more time it all takes, the more profitable the accounting firms become. No wonder they take out advertisements praising Sarbanes-Oxley!

In response to these developments, the “Pollock Proposal” is to expand Sarbanes-Oxley internal control requirements to cover the accounting firms themselves. Since they impose huge costs and nitpicking procedures on everybody else, they should have to go through the same Section 404 routines as a prerequisite to practicing on other people. I expect that, first, they would fail the reviews, and second, their views and reviews of others would become more reasonable.

Another perverse effect of Sarbanes-Oxley implementation is that, as another company wrote to the SEC, “External auditors are reluctant to give advice with regard to interpretation and application of complex accounting rules to avoid possible criticism from the PCAOB in regards to their independence.” A related comment: “Almost every significant audit-related decision is now being referred to the firm’s national offices rather than being addressed at the practice level.”

In other words, the PCAOB environment has made public accountants afraid to carry out the core function which defines a profession: exercising judgment. I consider this the reduction to absurdity of the effects of Sarbanes-Oxley implementation on accounting behavior-- and a striking disservice to the companies trying to cope with the ever more convoluted accounting rules propounded by the FASB. Note that this issue suggests that we also need to review the PCAOB.

Reform of Sarbanes-Oxley Implementation

Learning from unambiguous experience, Congress now has the opportunity to correct the expensive morass of problems resulting from the implementation of Sarbanes-Oxley in ways neither it nor anyone else ever intended, and to bring the costs to shareholders and the benefit to shareholders into balance.

Here's what I believe Congress should do:

1. Enact the provisions of HR 1641, introduced last year by Congressman Jeff Flake of Arizona. HR 1641 would make Section 404 of Sarbanes-Oxley voluntary, as opposed to mandatory. This approach would be well suited to a market economy and a free society.

If investors actually want the kind of heavy internal control documentation 404 demands, then the companies will do it because investors will demand it. Investors will punish those companies which opt out.

If, on the other hand, investors conclude that resources would be better spent elsewhere-- on research, or introducing new products, or customer service, for example-- then companies will do that and the investors will react accordingly.

2. If a totally voluntary approach be viewed as politically impossible, at a minimum make Section 404 voluntary for smaller public companies. Exemption from these requirements for these companies is recommended by the SEC's Advisory Committee on Smaller Public Companies.

I believe that "voluntary with disclosure and explanation" would be a better concept than simple "exemption." The company should decide what approach it will take to internal control certification and explain to its investors why it has so chosen. Investors can consider the company's logic and make up their own mind.

3. Instruct the PCAOB to change its review standard from "other than a remote likelihood" to "a material risk of loss or fraud." I think this is essential to improve the implementation behavior of the accounting firms.

4. State clearly that Congress does not have the naïve belief that accounting is something objective, but rather understands, as every financial professional does, that accounting is full of more or less subjective judgments, estimates of the unknowable future, and debatable competing theories. As the saying goes, it is art, and by no means science.

Therefore the express instruction of Congress should be that consultation, judgment and professional advice on the application of accounting standards is expected and demanded of accounting firms.

5. Instruct the PCAOB to require a Section 404 regime for the public accounting firms themselves, as a condition of their public trust, on the same standards as apply to public companies.
6. Mandate a report from the SEC and the GAO comparing the British principles-based Turnbull Guidance on corporate risk controls to the approach taken by Sarbanes-Oxley implementation.
7. Bring the PCAOB under Congressional authority as a regulatory agency should be, subject to appropriations, oversight and a normal appointments process, and move PCAOB assessments, as they are for any other regulator, to the regulated entities.
8. Finally, enact a sunset or reauthorization requirement for Section 404 of Sarbanes-Oxley five years from now. That would be 2011, a decade after the scandals which gave it birth, with correspondingly greater experience, knowledge and perspective for all concerned.

I believe these steps would bring under control the unintended effects, which have proved so remarkably costly, bureaucratic and inefficient, caused by the way Sarbanes-Oxley has been implemented.

Thank you again for the chance to be here today.